Direct Loan Savings Estimates – Implications for Federal Student Financial Aid

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One of the more popular arguments in favor of the Administration's proposed shift to 100% government financed student loans is the favorable subsidy rate attached to direct loans. Since its inception, the direct loan program has been projected to save a considerable sum of money by taking advantage of interest rate arbitrage spreads between the government's cost of capital and the borrower-paid interest rate. Simply put, the government hopes to make more money by issuing loans itself than by relying on private sector participation to issue those same loans.

This hope is based on requirements included in the Credit Reform Act, which instruct federal scorekeepers to ignore actual cash flows, basing budget estimates of credit programs on assumed net present values. Since net present value is a credit term rather than an accounting term, mixing net present value estimates with cash basis accounting requires some extra analysis. This is done through interest rate reestimates, performed every year on federal direct loan accounts, to measure the true cash flow cost of operating government financed credit programs.

Since 1994, when the direct loan program first began originating loans, these reestimates have been reported, but rarely, if ever, taken into account by policymakers – simply because federal budget estimates are not required to incorporate them. This analysis explains why such consideration is necessary.

Direct Loan Projections and Actual Results

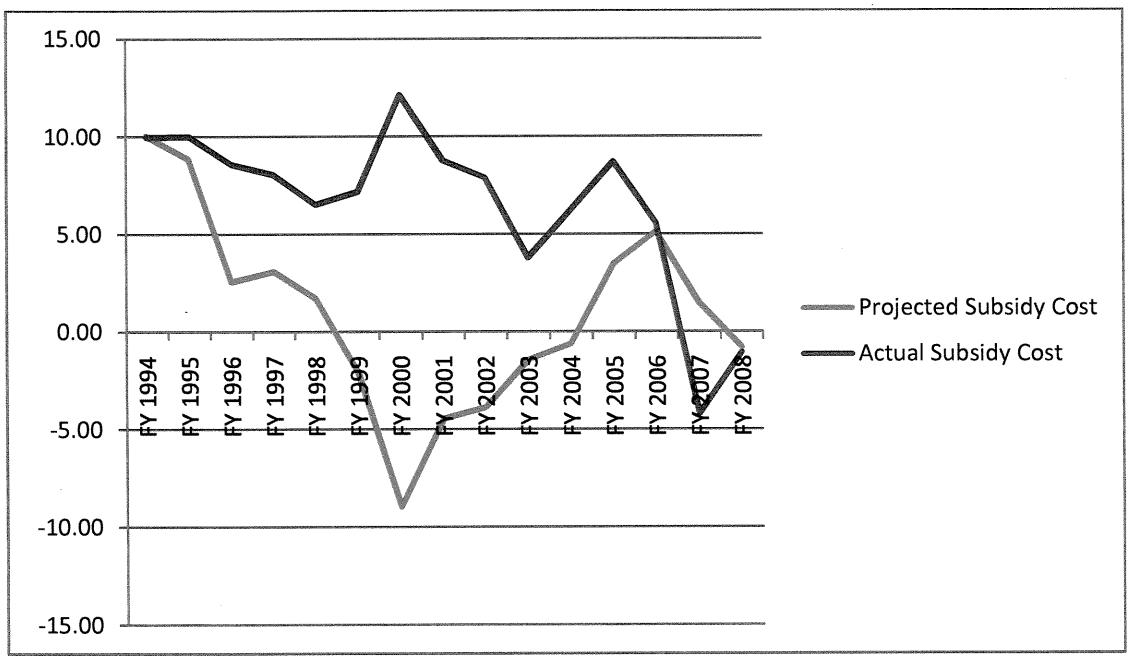
Subsidy costs, basically, are the costs associated with each student loan issued. In the case of direct lending, this excludes any administrative costs (by law), so the only costs taken into account are the government's cost of capital and the spread between the government's cost and the borrower's interest rate. Among the three types of borrowers loans (subsidized Stafford, unsubsidized Stafford, and GradPLUS loans), the borrower interest rate for loans originated during fiscal year 2009 ranges from 5.6% on subsidized Stafford loans to 7.9% on GradPLUS loans. Unsubsidized Stafford loans continue to carry a fixed 6.8% rate for all borrowers.

Under the current budget environment where Treasury borrowing rates are depressed relative to historical levels, the government is projected to enjoy a historically large arbitrage rate on direct loans. At the current (as of May 22, 2009) rate for 91-day Treasury notes, the government's cost of capital is 0.18 percent. Even on the lowest cost loan to the borrower, the subsidized Stafford loan, the government's spread would be 5.42 percent.

Student loan terms have fluctuated over time, ranging from fixed to variable rate loans with interest rates virtually all over the map. Since each cohort of loans has maintained its own terms and conditions, however, comparing cohorts of loans by fiscal year over time ensures that such variance is eliminated

from any analysis. Taking each year of loans separately, overall performance against estimates can be evaluated. The following chart shows the original subsidy cost estimate compared with current subsidy cost estimates by cohort of direct loans. As illustrated, for most years the subsidy cost is underestimated, usually substantially.

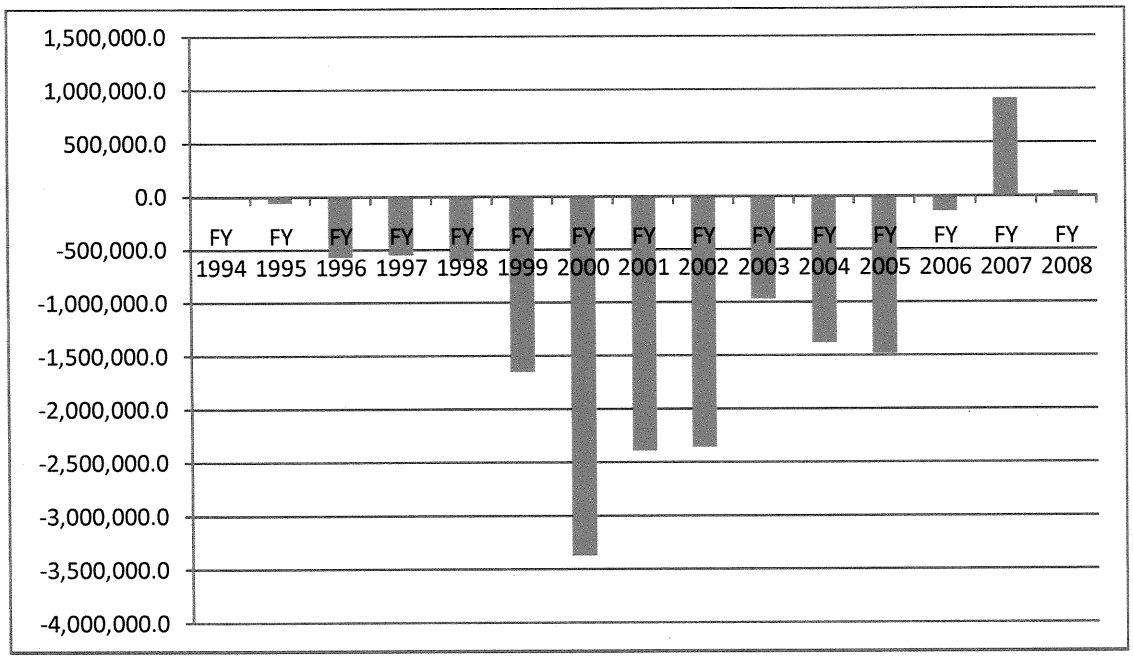
Figure 1 - Projected v. Actual Subsidy Costs for the Direct Loan Program



Recent years' estimates are closer to actual estimates, but many of these borrowers may still be in school, or in the 6-month deferment period after leaving school. It is unlikely that a large majority of these cohorts have entered repayment, meaning the cost to the government so far is only the cost of holding the loan – as repayments begin to come in, fluctuations in interest rates are likely to negatively impact subsidy cost estimates as with prior cohorts. Over time, the spread between subsidy costs on loans in repayment has tended to expand, as the middle section of the range shows. On average, the reestimated subsidy costs exhibit a differential of 5.6 percent since the program's creation, a significant deviation in terms of budgetary impact.

The budgetary impact is illustrated below. Over its lifetime, the direct lending program is likely to lose more than $15 billion against estimates on outstanding loans, excluding administrative expenses (which would only create larger losses against estimates). In fact, the only years for which the program has not substantially adjusted its estimated subsidy costs are years in which the majority of borrowers are still unlikely to have entered repayment. Without the projected savings associated with the FY07 and FY08 cohort of loans, the net losses against projections reach nearly $17 billion.

Figure 2 - Net Budgetary Losses from Reestimated Subsidy Costs



Application to the Current Debate

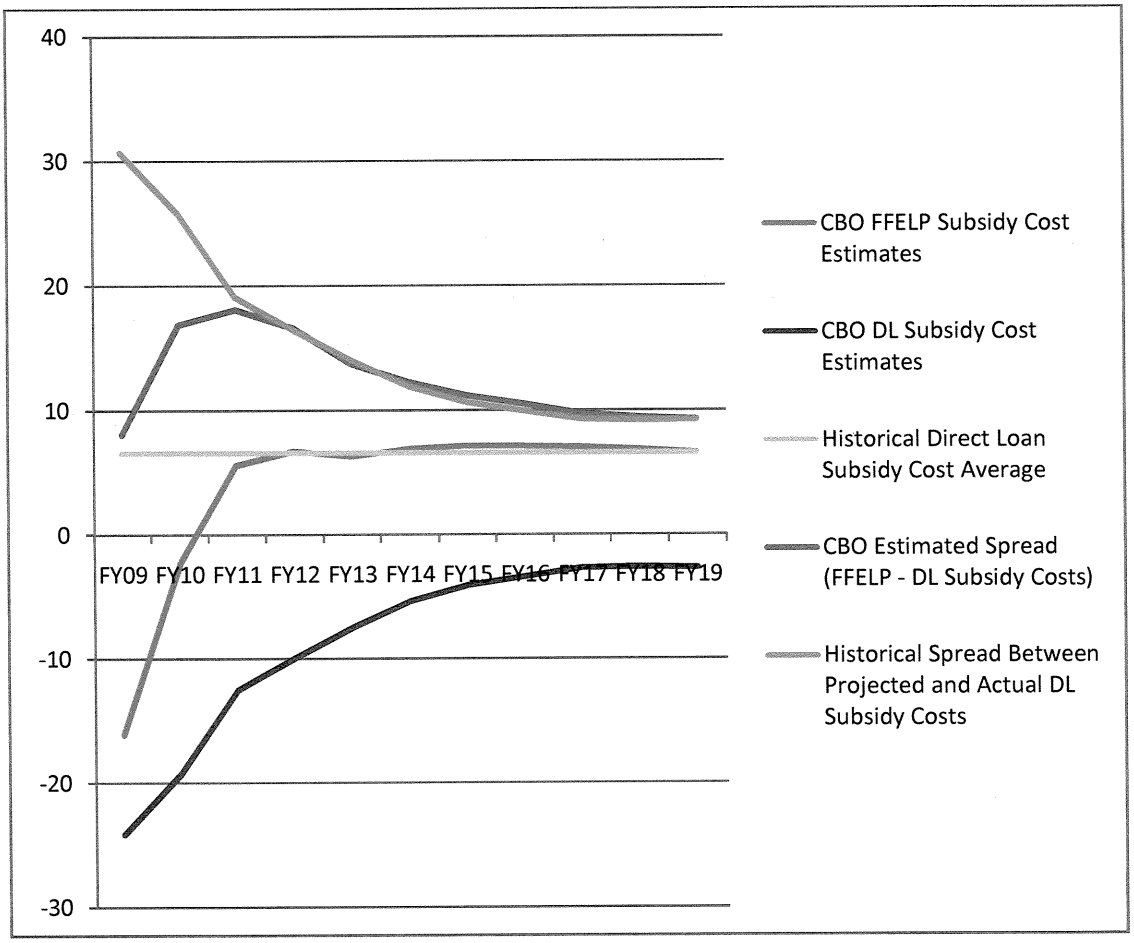
Since much of the focus around the Administration's proposal highlights the application of projected savings to future student financial aid awards, it would make sense to base future projections on prior reestimate data, particularly if those projections were to be used to offset considerable increases in federal spending.

The Congressional Budget Office assumes direct loan subsidy costs ranging from – 2.60% to -24.13%. Since about 30 percent of new student loans are made by the direct loan program today, the only savings associated with the President's proposal are those accumulated through a shift in originations from the Federal Family Education Loan Program (FFELP) to direct lending. The FFEL program currently provides the majority of student loan funding and for which the CBO estimates subsidy costs ranging from -16.14% to 7.09%. The median reestimated subsidy cost for all direct loan cohorts is 6.54, including recent years where the reestimated subsidy cost is still negative.

CBO assumes that over the ten-year budget window the spread between subsidy costs for direct loans and FFELP loans will vary between 7.99% and 18.07%. The difference in subsidy costs accounts for all of the savings projected to come from switching which program originates all new loans. However, comparing CBO's projections with the historical average shows a much smaller spread between FFELP and DL, and, more importantly, an enormous spread between projected and historical performance for direct loans. Comparing CBO's estimated subsidy cost for direct loans to the portfolio's historical

performance yields a gap of 9.22% to 30.67%. That level of variance suggests that CBO's estimates are, at best, problematic. At worst, the CBO estimates portray a picture of savings that is completely wrong.

Figure 3 - CBO Subsidy Cost Projections and Historical Direct Lending Subsidy Costs



Substituting the median historic subsidy cost rates in lieu of CBO's direct lending subsidy cost estimates provides an indication of what might happen to the projected savings if the direct loan program performs as well as it has historically, rather than as it has been projected. As a point of reference, the CBO never once assumes a positive subsidy cost for direct lending over the ten year budget estimate window. When projecting total volume against the historical average based on the program's actual performance rather than against CBO's projected subsidy costs, the projected savings associated with a switch to direct lending evaporate.

The implications for student financial aid are tremendous. Where CBO estimates suggest that a switch to all new loans being originated through direct lending would produce substantial savings, the historical performance of direct lending suggests that the costs will more than make up the difference in savings through later reestimates. Taking each component of CBO's estimates separately, the total error can be calculated. Under CBO's baseline assumptions, the direct lending program should net the government

roughly $20 billion over the 10-year budget window. Using historical performance data, however, the direct lending program is likely to cost the government $20 billion, a $40 billion swing.

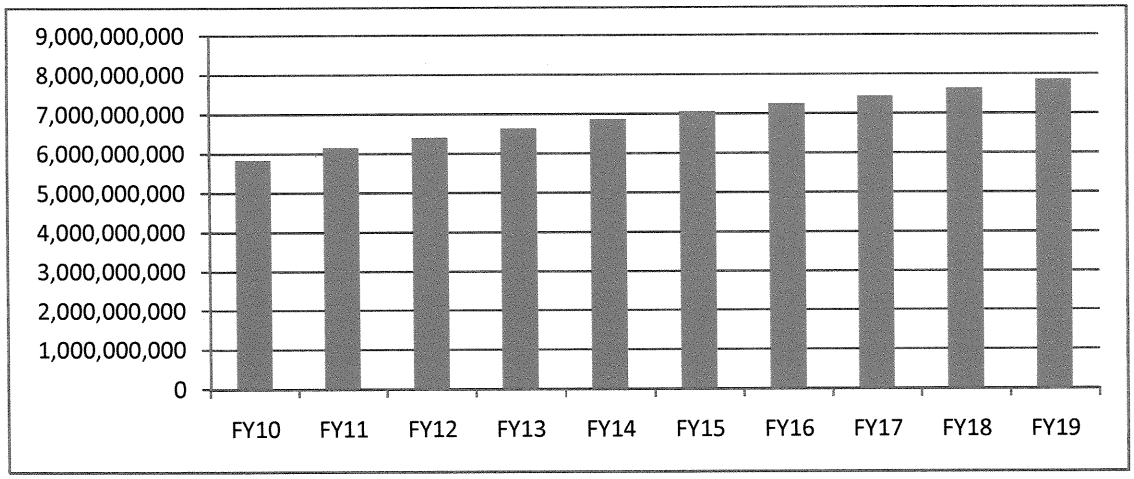
Similarly, the projected savings associated with a switch are projected by CBO to net the government $94 billion in savings over the 10-year budget period. Using historical performance data the true costs of originating loans through direct lending are likely to result in a next cost of nearly $5 billion, eliminating all of the savings associated with the proposed shift and creating an enormous shortfall. In the following table, each component is measured independently to demonstrate the cumulative impact of the errors in scorekeeping.

Table 1 - Cost Differentials Using CBO Projected and Median Historical Subsidy Cost Estimates for Direct Lending

Component	Projected Performance (CBO Estimated Subsidy Costs)	Projected Performance (Median Historical Subsidy Costs)	Net Difference
Existing Direct Lending Portfolio	-$20.067 billion	$20.205 billion	$40.272 billion
New Direct Loan Volume (subsidy cost differential, FDLP v. FFELP)	-$94.103 billion	$4.858 billion	$98.963 billion
Total Error			**$139.235 billion**

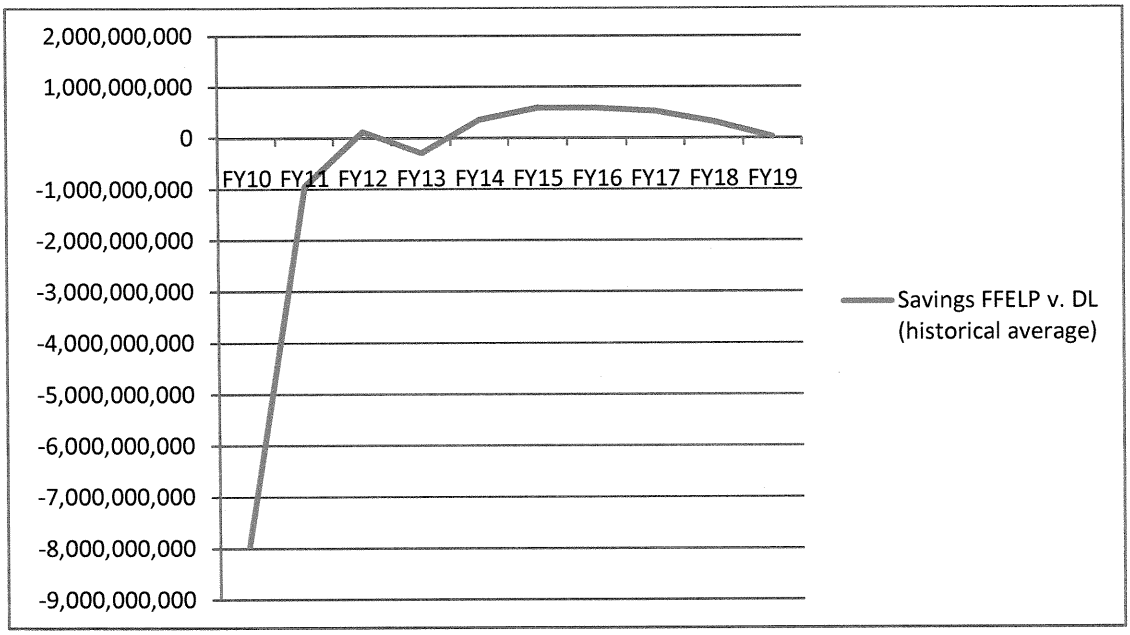
Whether the savings are applied to student aid or deficit reduction, the bottom line is that direct lending will produce far less toward either purpose than projected, leaving taxpayers holding the bag. Contrasting historical costs of a 100% direct lending system with CBO estimates suggests an error margin of tens of billions of dollars over the ten-year budget window. Rather than saving the $94 billion projected over the ten-year window, direct lending is likely to produce $25 billion in costs, a net adjustment of over $139 billion.

Figure 4 - Costs Associated with a 100% FDLP System



Finally, the fallback position of many direct loan advocates, asserting that direct lending is still historically cheaper to operate than FFELP, is inaccurate. Comparing the costs where either program would be responsible for 100% of new loan originations shows that a switch to 100% FFELP would prove more financially beneficial to the federal budget than a switch to 100% direct lending, since the CBO estimates subsidy cost for FFELP to be lower for three of the next ten years, generating savings against a 100% direct lending alternative, and for those years in which the FFELP subsidy cost is higher, it is within 50 basis points of direct lending's historical average. On balance, a switch to 100% FFELP is more likely to produce real savings than a switch to 100% direct lending.

Figure 5 - Costs/Savings Associated with 100% FFELP v. 100% FDLP Origination (using median historical subsidy cost estimates)



As seen in this chart, the cost advantages of a 100% direct lending origination system are considerably smaller than anticipated by CBO when compared using median historical cost estimates for direct lending. In the instances where direct lending would be cheaper on a subsidy cost basis, the differential substantially less than CBO predicts, topping out at just under $600 million in savings for the cohort of loans originated in FY15, for example. Even using this method of calculation and excluding administrative costs incurred, the historical performance of direct lending should give considerable pause to policymakers contemplating an expansion of federal financial aid based on assumed arbitrage advantages exhibited by the direct lending program.

Cash Flow Costs Associated with Direct Lending

Because direct lending is a credit program it is not accounted for in cash terms – a result of the Credit Reform Act. However, cash flows are still reported in the budget, along with the cash flow impacts of reestimated program costs. Although these costs will track subsidy cost reestimates to a certain degree, these figures represent actual costs to the federal government that result from direct lending shortfall for specific fiscal years. The government publishes estimated and actual costs for the direct loan program account, which provide useful data for comparing cost increases over initial projections. For example, the FY10 budget produced by the Office of Management and Budget reports that administrative costs for the direct lending program were $5.334 billion in FY08, while the FY08 budget estimated program costs at only $525 million, a significant error margin. Prior year budget estimates demonstrate a similar trend:

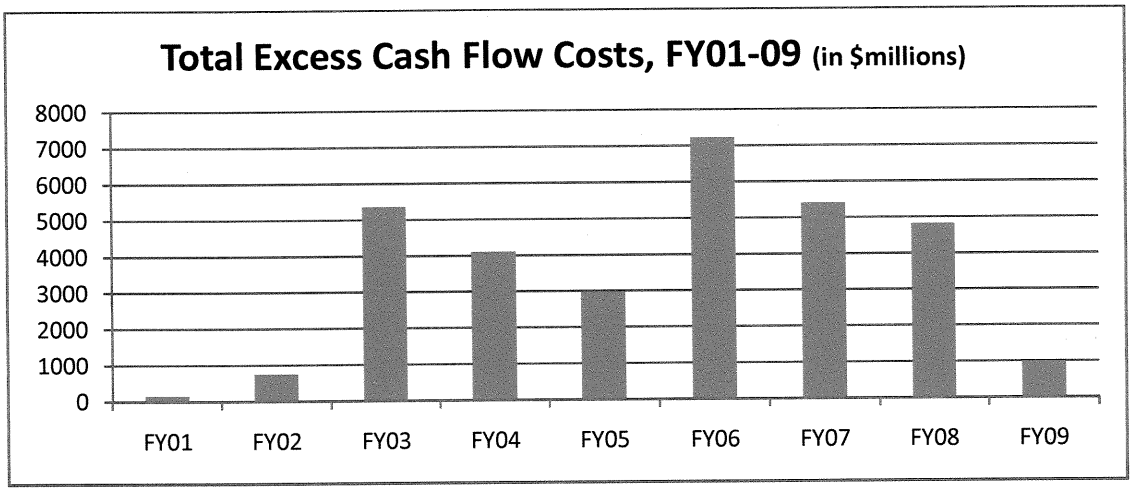
Table 2 - Cash Flow Errors for the Federal Direct Student Loan Program, FY06 - FY10

	FY06	FY07	FY08	FY09	FY10
Estimated Outlays	-$375 million	-$5 million	$525 million	$402 million	$3 million
Actual Outlays	$6.842 billion	$5.391 billion	$5.334 billion	$1.421 billion*	Not reported
Costs associated with program reestimates	$4.907 billion	$4.692 billion	$5.301 billion	$1.386 billion*	Not reported
Total Costs from with Errors	**$7.217 billion**	**$5.396 billion**	**$4.809 billion**	**$1.009 billion**	**Not reported**

* Estimated

The key contrast between these figures and future subsidy cost projections is that these cash flows represent actual obligation of funds and outlays for program costs per fiscal year while future projections of net present values still include assumed future worth of loans. In many ways, these figures are more damning for direct lending than future projections based on historical subsidy cost performance, in that over the past nine fiscal years direct lending has already cost taxpayers $31 billion more than expected, based on the government's own estimates, and the toll is likely to go much higher. Total costs associated with reestimate errors for fiscal years 2001 through 2009 are shown below. Prior

fiscal years also provide actual and estimated outlays, but do not report reestimated costs, precluding a longer term analysis of true cash flow costs of the direct lending program.



Conclusions

The Administration's proposal to completely do away with FFELP is predicated on the idea that the switch to direct lending will produce considerable savings, with which the government can expand financial aid to students. The historical performance of direct lending, however, presents a significant challenge to that assumption in that projected future earnings from the direct loan program have never materialized. In fact, rather than saving the $94 billion projected over the next ten years, direct lending is more likely to produce net adjusted costs of $139 billion. Given recent changes in the FFEL program, it is now more likely that a switch to 100% FFELP would produce more real savings in terms of government cash flow than a switch to 100% direct lending. Furthermore, on pure cash basis of accounting, direct lending has already cost over $31 billion more than expected in only the past nine years.

Because direct lending has historically originated only a small percentage of student loans, these cost differentials are likely to be exacerbated should the Administration's proposal be enacted. Instead of producing real savings, the Administration's proposal is more likely to place a tremendous burden on taxpayers and contribute a substantial weight to the national debt by obligating future funds that will never actually be produced through the anticipated shift to direct lending.

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